BROWNEDWARDS

ESTATE PLANNING INSIGHTS

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IS NOW THE TIME FOR A CHARITABLE LEAD TRUST?

Families who wish to give to charity while minimizing gift and estate taxes should consider a charitable lead trust (CLT). These trusts are most effective in a low-interest-rate environment, so conditions for taking advantage of a CLT currently are favorable. Although interest rates have crept up in recent years, they remain historically low.

2 types of CLTs

A CLT provides a regular income stream to one or more charities during the trust term, after which the remaining assets pass to your children or other noncharitable beneficiaries. If your beneficiaries are in a position to wait for several years (or even decades) before receiving their inheritance, a CLT may be an attractive planning tool. That's because the charity's upfront interest in the trust dramatically reduces the value of your beneficiaries' interest for gift or estate tax purposes.

There are two types of CLTs: 1) a charitable lead annuity trust (CLAT), which makes annual payments to charity equal to a fixed dollar amount or a fixed percentage of the trust assets' initial value, and 2) a charitable lead unitrust (CLUT), which pays out a set percentage of the trust assets' value, recalculated annually. Most people prefer CLATs because they provide a better opportunity to maximize the amount received by one's noncharitable beneficiaries.

Typically, people establish CLATs during their lives (known as "inter vivos" CLATs) because it allows them to lock in a favorable interest rate. Another option is a testamentary CLAT, or "T-CLAT," which is established at death by one's will or living trust.

Another issue to consider is whether to design a CLAT as a grantor or nongrantor trust. Nongrantor CLATs are more common, primarily because the grantor avoids paying income taxes on the trust's earnings. However, grantor CLATs also have advantages. For example, by paying income taxes, the grantor allows the trust to grow tax-free, enhancing the beneficiaries' remainder interest.

Interest matters

Here's why CLATs are so effective when interest rates are low: When you fund a CLAT, you make a taxable gift equal to the initial value of the assets you contribute to the trust, less the value of all charitable interests. A charity's interest is equal to the total payments it will receive over the trust term, discounted to present value using the Section 7520 rate, a conservative interest rate set monthly by the IRS. As of this writing, the Sec. 7520 rate has fluctuated between 2.35% and 2.55% so far this year.

If trust assets outperform the applicable Sec. 7520 rate (that is, the rate published in the month the trust is established), the trust will produce wealth transfer benefits. For example, if the applicable Sec. 7520 rate is 2.5% and the trust assets actually grow at a 7% rate, your noncharitable beneficiaries will receive assets well in excess of the taxable gift you report when the trust is established.

If a CLAT appeals to you, the sooner you act, the better. In a low-interest-rate environment, outperforming the Sec. 7520 rate is relatively easy, so the prospects of transferring a significant amount of wealth tax-free are good. Contact us for more details.

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